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Taxing the "Cloud" on the Horizon


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We all recognize that many states are pressed for revenue in this economy. Tax practitioners have seen states cast wide nets around potentially taxable transactions in the sales and use tax arena -but the Cloud? Who would have thought taxing authorities' sights would set on the Cloud? In this technological age with computers, software, and the Internet and the myriad of services related to these enterprises, state taxing authorities have focused attention on sales and use tax inquiries and audits related to them. As such, transactions involving "cloud computing" seem to be attracting more and more attention from state taxing authorities and the future treatment of Cloud offerings as "property" subject to state sales and use tax is at best, uncertain.

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As discussed in *Is Your Business Venturing into the Cloud? Beware of the Fine Print?*[1] cloud computing is a computer networking model that gives users on-demand access to shared software applications and data storage. The Cloud offers businesses a flexible, low cost alternative to hardware-heavy IT infrastructure traditionally needed to operate a technology system. For example, by storing data off-site in the "cloud," one may be able to drastically reduce the size of one's server room. Further, off-site storage offers more rapid disaster recovery, allowing one's business to get back up and running in a matter of hours or days rather than weeks or months. The Cloud also takes the guess-work out of determining future IT needs - as business grows (or contracts) one can adjust Cloud needs accordingly and with relative ease and low cost. Nevertheless, another important consideration before leaping head-first into a cloud services agreement is consideration of potential tax consequences.

Fundamental to any venture into the Cloud is an agreement that sets forth the parameters of the relationship between the Cloud provider and the customer, services performed, warrantees and obligations, and related terms. States such as Michigan and New York have taken the position that these Cloud transactions

are subject to sales and use tax because they are retail sales of tangible personal property. This position comes from the traditional notion in the area of state sales and use tax that when a retail sale of non-business property that is tangible in nature (*i.e.*, footwear, CDs, beverages, etc.) occurs, there is a sales tax imposed. These states view the use of the Cloud as analogous to purchasing software - and they may not be entirely off the mark in their opinion. Arguably, when one pays for access to software and related products in the Cloud, one acquires a right to use that software, which use is tantamount to "possession." As such, use of the Cloud may be considered similar to purchasing software from a storefront.

2008, New York State's Department of Taxation and Finance has treated these cloud computing transactions as sales of tangible personal property subject to New York sales tax at a rate of 4%, with a maximum sales tax after local surtaxes of 8.875%.

There has not been much guidance on this issue. New York is the most notable of the states leading the charge to impose a tax on Cloud services agreements. Since 2008, New York State's Department of Taxation and Finance has treated these cloud computing transactions as sales of tangible personal property subject to New York sales tax at a rate of **4%**, with a maximum sales tax after local surtaxes of **8.875%.** The leading ruling on the issue, TSB-A-08(62)S (November 24, 2008), stems from a request from Adobe Systems for an advisory opinion as to whether its charges to its customers to access on-demand software available for use on its website would be subject to New York sales tax as "tangible personal property." The ruling answered in the affirmative, reasoning that the tangible personal property definition was clearly met, "regardless of the medium by which the software was delivered to the purchaser." The ruling found that there was a transfer of possession when a user downloaded the Adobe software which was tantamount to actual possession of the tangible personal property and therefore subject to tax. New York taxed users who were located in New York. Michigan has apparently followed New York on this issue.

This is certainly a harsh result, especially for those businesses in jurisdictions who follow New York's lead, including states such as New Jersey, because they base much of their sales and use tax statutes on New York's and currently tax retail sales of software, generally. Some states such as Texas have introduced bills on this subject; while others such as Louisiana and Illinois are evaluating the issue.

In contrast, an opposing view - although not fully accepted - emphasizes that most current sales tax statutes are outdated and the recent push to stretch the scope of these laws is really an improper attempt by states to raise revenue on what should be seen as non-taxable Internet transactions, and not purchases of tangible personal property like software. Since there has been no "retail sale" and no transfer of ownership of Cloud services, there should be no tax. As businesses continue to gravitate to the Cloud, there certainly will be more on this issue in other states in the near future.

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[1] Bloomberg Law Reports - Technology Law, Vol. 3, No. 9 (May 2, 2011).